RAILWAY VALUATION AND THE COURTS

I

THE railways of the country have now secured a statutory rule of rate-making, which requires the Interstate Commerce Commission to fix such rates as will bring five and a half per cent (or at its discretion six per cent) upon the "fair value" of the aggregate railway property within a given district. Upon this clause the hopes of the financial community are centered. It is to bring stability and certainty of return, to restore railway credit, to place rigid restraints upon a supposedly hostile regulating body. It is to substitute an inflexible rule for an uncertain administrative discretion.

Whether or not these hopes are well founded obviously depends upon whether the clause does contain a rule which may be applied with certainty and precision. Five and a half per cent is definite enough, but what is the "fair value" of the railroads? For the present it is obvious that the Commission can do little more than arbitrarily assign a value to the railway property in each rate district. But for the future "fair value" must be derived from the findings of the Commission in its gigantic task of valuing the railroads of the country under the Valuation Act of 1912. How certain and stable a result does this valuation promise?

For better or for worse, we must now take it to be settled that under our American system of jurisprudence the problem is a constitutional one, and the Supreme Court the final arbiter. The Interstate Commerce Commission will before long complete its task of inventorying and appraising every item of railroad property in the United States. Field parties are making engineering surveys of every mile of track, appraisers are examining land values, accountants and experts are digging into historical records and corporate accounts. So far as a vast expenditure of money and indefatigable zeal can accomplish the task, the facts in the case are being brought to light.[1] As to findings of fact, it may be assumed

[1] See "Railroad Valuation by the Interstate Commerce Commission," by H. B. Vanderblue, in 34 QUART. J. OF EC. 22.

that the conclusions of the commission will be deemed well-nigh conclusive, in actual practice if not in legal theory.[2] But these underlying facts constitute merely the raw material out of which the final decision must be made. The principles according to which the raw material is to be combined must be passed upon by the Supreme Court, and must square with the Supreme Court's conception of constitutional theory.

The object of this paper is to inquire into the premises upon which the court's function, as final court of review in valuation cases, must rest. I shall not attempt any detailed analysis of cases, nor any voluminous marshaling of economic data. The inquiry will lead, necessarily, into an analysis of the nature of the problem which will confront the court, and an examination of those decisions of the court which will throw light upon its own conception of the premises upon which it must act. The inquiry into the nature of the relation between the public utility and the community will lead to certain conclusions which seem to me to have a practical bearing upon some of the problems now agitating the legislature and the courts.

When railroad regulation first became a subject of political and legal controversy, the constitutional issue was simple. The railroads claimed that they were entirely exempt from rate regulation. They operated under charters granted by the states, which in so many words gave them the right to fix their own passenger and freight rates, and these charters were contracts, sacred from the touch of state legislatures. Their property was private, they were in private business operating for profit, and any state interference not specifically authorized in their charter violated those general guarantees in the Fourteenth Amendment, the sweeping character of which lawyers and courts were just beginning to appreciate. The claims on the other side were just as clear cut. The lawyers of the anti-railroad forces claimed that any regulation of rates, however drastic, was valid. The charter provisions giving the railroads power to fix rates meant no more than power to fix rates in accordance with, or in the absence of, state legislation. And apart from charters, the railroad business was a public business, resembling in many ways the businesses of trucking, ferrying, carriage driving, and the like, which the British Parliament had traditionally regu-

[2] *Cf.* Van Dyke *v.* Geary, 244 U. S. 39 (1916).

lated. Regulation of railroad rates was therefore a proper legislative function and quite beyond the jurisdiction of the courts. No one ever heard of a British court inquiring whether a schedule of rates for wagoners or ferrymen, fixed by Parliament, was reasonable. If a legislature fixed unreasonable rates, the people had their remedy at the polls, not in the courts.

In the granger cases,[3] in 1876, a majority of the Supreme Court sustained to its full extent the popular view. It not only upheld the power of the legislature to fix rates, but it declared that the legislature alone was the judge of what was a reasonable rate. "The controlling fact is the power to regulate at all. If that exists, the right to establish the maximum of charge, as one of the means of regulation, is implied." If the rate has been improperly fixed, the legislature, not the courts, must be appealed to for the change. The argument that the charter protected the corporations against rate regulation was met by pointing to the general clause in state constitutions reserving the right in the legislature to alter all corporate charters.

One point in this early controversy it is important to understand. There is much discussion whether rate fixing is in its nature a "judicial" or a "legislative" function. This was a period in the history of American jurisprudence when discussions of this sort were popular. The separation of powers into executive, legislative, and judicial was looked upon as more than a mere differentiation of functions based upon practical considerations; it was thought to be the manifestation of an inherent truth. The pseudo-philosophy of the period regarded certain governmental acts as in their nature judicial, and hence never to be exercised, under the constitution, by either the legislative or the executive branch. The opponents of legislative rate regulation tried to bring rate fixing into this category. At common law, in the absence of legislation, a public utility was bound to charge no more than a reasonable rate, and if a shipper or a passenger complained of an act of extortion, it was for the court to decide whether in fact the rate was unreasonable. In such a case reasonableness was a judicial question. So much the court in the granger cases readily admitted. But it declined to draw the conclusion that a rule of the common

[3] Munn *v.* Illinois, 94 U. S. 113 (1876); Chicago, B. & Q. R. Co. *v.* Iowa, 94 U. S. 155 (1876); Peik *v.* Chicago, etc. Ry. Co., 94 U. S. 164 (1876); and cases following.

law, leaving to the courts the issue of reasonableness, could never be changed by the legislature. Chief Justice Waite pointed out that as soon as the legislature had changed this common-law rule by substituting a specific schedule of rates, reasonableness ceased to be an open question on which courts could pass. Potentially, rate regulation was a legislative question; it was merely by default of the legislature that the courts had anything to do with it.

If the matter had rested there, the constitutional history of rate regulation would have been brief. If a legislature had uncontrolled power over railroad rates, it could delegate this power to an administrative tribunal, and make the decision of that tribunal conclusive on all questions of reasonableness. The courts would have nothing to do with the matter. But the railroads represented immense property investments. The granger legislation aroused bitter political passions, and grave fears among those who believed that the welfare of the country depended upon the security of property. In case after case, as it came before the Supreme Court, the leaders of the bar appealed to the court not to leave the vast interests of private stockholders at the mercy of radical state legislatures. To have withstood this appeal would have been utterly inconsistent with the individualistic spirit which pervaded American jurisprudence in the latter part of the nineteenth century. Some method must be devised by which the courts could check the assaults of western legislatures upon established property rights. The court obviously could not go back on its decision in the granger cases, and hold that railroads were completely free from legislative interference. The principle was too firmly established in the precedents. The problem was to find some midway course which would preserve the power of regulation, but would put a reasonable check on the exercise of that power, when it attempted to cut too drastically into property values.

How the Supreme Court, in the series of cases culminating in *Smyth* v. *Ames*,[4] finally hit upon what seemed a solution of this problem, is a familiar story. When *Munn* v. *Illinois*[5] was before the court, the juristic development of the Fourteenth Amendment was still in its infancy. Only four years before, in the Slaughter House cases,[6] the court had seemed reluctant to extend its protection to other classes than to Negroes. To hold that a statute on a subject

[4] 169 U. S. 466 (1898). [5] 94 U. S. 113 (1876). [6] 16 Wall. (U. S.) 36 (1872).

which was in its nature legislative, conferring power which the British Parliament had traditionally exercised, and in which the forms of due process were observed, was lacking in due process, would at that time have seemed a bold step for the court to take. Where the legislature had delegated its power to a commission, and made the decision of that commission final, there was at least a possible argument that the railroad was deprived of its traditional right to due process by judicial inquiry.[7] But where the legislature itself fixed fares directly, or where a commission fixed rates under a law which provided for a judicial review, there were obvious difficulties in holding that the state was acting without due process.

The argument which finally prevailed, rested on the analogy of the law of eminent domain. If the federal government were to take physical possession of a railroad, obviously it would be necessary under the Fifth Amendment to pay just compensation. If instead of taking possession it issued an order compelling the railroad to give the use of its property to the public free of charge, this would virtually be taking the property for public use without just compensation. If it allowed the railroad to receive compensation for its services, there would still be a question for the court whether the compensation was just. It required, perhaps, a slight wrench to make a doctrine which required the government to *pay* just compensation, serve the purpose of requiring the government to permit the railroads to collect just compensation from their patrons; but the matter was never very minutely inquired into. Another difficulty also had to be overcome. The cases that came up to the Supreme Court involved state laws, not federal laws. There is no clause in the Constitution expressly forbidding a state to take property for public use without just compensation. It was necessary to go a step further, and hold that to take property without making what the Supreme Court thought to be just compensation, was to take it without due process of law, and this even where the forms of due process were faithfully adhered to.

Through this difficult pathway the court had to find its way, and it is no wonder that its progress was slow and hesitating. It threw up a kind of *ballon d'essai* in 1886, in the form of a *dictum* that "under pretense of regulating fares and freights, the State cannot require a railroad corporation to carry persons or property

[7] Chicago, etc. Ry *v.* Minnesota, etc. Ry. Co., 134 U. S. 418 (1890).

without reward; neither can it do that which in law amounts to a taking of property for public use without just compensation, or without due process of law." [8] The following year it still expressed a doubt whether "it would under any circumstances have the power" to hold a state rate regulation void on the ground that it was confiscatory.[9] A year later the *ballon d'essai* of 1886 was again thrown out.[10] But in 1892 the court was still in doubt whether it could ever hold that a rate fixed by the state legislature was unreasonable.[11]

Before pursuing this germinating theory to its full bloom in *Smyth* v. *Ames*, it is instructive to notice that in its earlier period of growth it was not without a rival. One member of the court, Justice Harlan, made valiant efforts to swing the court over to another theory, which would accomplish the same general result of limiting without abrogating the regulating power of the state. Justice Harlan participated in his first rate case in 1882.[12] In that case he voted with the majority in holding that the rate law in question was constitutional. But he filed a concurring opinion in which he developed a constitutional theory which would put a clear limit on the regulating power. The railroad's charter, he said, gave the railroad directors the power to fix "such rates of toll . . . as they shall by their by-laws determine." In view of the common-law history of public callings this must mean, he pointed out, "such *reasonable* rates of toll." The corporation had, therefore, a charter right through its directors to fix reasonable rates; they had no charter right to fix more than reasonable rates. A statute which merely regulated rates down to the level of reasonableness did not infringe their charter right, but a statute which reduced rates below the level of reasonableness was an infringement of charter rights which, under the principle of the Dartmouth College case, would be invalid under the contract clause of the Federal Constitution. And whether or not this charter right had been infringed was necessarily a judicial question, not a legislative one.

Here were two alternative theories, which seemed to achieve the result the court was groping for. Each left the power to regulate in

[8] Stone *v.* Farmers' Loan and Trust Co., 116 U. S. 307, 331 (1886).
[9] Dow *v.* Beidelman, 125 U. S. 680, 691 (1888).
[10] Georgia R. R. & Banking Corp. *v.* Smith, 128 U. S. 174 (1888).
[11] Budd *v.* New York, 143 U. S. 517, 548 (1892).
[12] Ruggles *v.* Illinois, 108 U. S. 526 (1883).

existence, and each established, without any very violent stretch of legal reasoning, a means of judicial protection against abuse of the power. In *Stone* v. *Farmers' Loan and Trust Co.*,[13] in 1886, the two theories seemed to come into sharp conflict. This was the case in which Chief Justice Waite sent up his first *ballon d'essai* under the Fourteenth Amendment. The statute in question authorized the railroad commission to reduce rates "so as to allow a fair and just return on the value of such railroad." Under the eminent domain analogy this was precisely what the railroad was entitled to receive. Justice Harlan, however, dissented from the decision, pointing out that the statute might authorize a reduction below the level of reasonableness, so long as a fair return on the "value" was allowed. But there was no necessary conflict between the two theories. A slight modification of Justice Harlan's conception of reasonableness would bring them into harmony. In *Budd* v. *New York*,[14] in 1892, the rate regulation was sustained on the ground that "the records do not show that the rates fixed by the statute are unreasonable, *or* that property has been taken without due process of law." In the Texas rate cases of 1894,[15] a unanimous court held that the rates fixed by the state were unconstitutional. There is only one opinion, and it appears to go on both the contract theory of Justice Harlan and the property theory of Chief Justice Waite. In discussing a preliminary jurisdictional question, Justice Brewer points out that it is an open question for the court to consider whether "there is not implied in the grant of the right to construct and operate, the grant of a right to charge and collect such tolls as will enable the company to successfully operate the road and return some profit to those who have invested their money in the construction." And a little later he says:

"If the state were to seek to acquire the title to these roads, under its power of eminent domain, is there any doubt that constitutional provisions would require the payment to the corporation of just compensation, that compensation being the value of the property as it stood in the markets of the world, and not as prescribed by an act of the legislature? Is it any less a departure from the obligations of justice to seek to take not the title but the use for the public benefit at less than its market value?" [16]

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[13] 116 U. S. 307 (1886).

[14] 143 U. S. 517 (1892).

[15] Reagan *v.* Farmers' Loan & Trust Co., 154 U. S. 362 (1894).

[16] *Ibid.*, 410.

The final holding was that the state law was "unjust and unreasonable." Apparently the court was still holding open the opportunity of selecting either or both of the theories, as might prove expedient.

One of the Texas rate cases involved not a state but a federal corporation.[17] Here the contract theory obviously broke down. But this of itself would not be an insuperable obstacle to the application of Justice Harlan's theory in a modified form. The federal charter gave the corporation the right to fix reasonable rates. It would have been simple to hold that this federal grant of power carried with it an implied limitation of the right of the state to reduce its rates below the point of reasonableness, just as the grant of a federal charter to carry on the banking business had been held to carry with it an implied limitation of the taxing power of the state.[18] The court delivered only a brief separate opinion in this case, however, which does not make it clear on what theory it was relying.

In these Texas cases we hear the last of Justice Harlan's theory of an inviolable charter right to collect reasonable rates. In *St. Louis & San Francisco Railway* v. *Gill*,[19] the discussion turned entirely on the Fourteenth Amendment, and in *Covington, etc. Turnpike Co.* v. *Sandford*,[20] and *Smyth* v. *Ames*,[21] Justice Harlan, the originator of the contract theory, who ten years before had considered a statute unconstitutional which allowed only a "fair and just return on the value" of the railroad, himself delivered an opinion for a unanimous court, based squarely on the Fourteenth Amendment. A railroad corporation, he said, is a "person" under the Constitution, and a statute or regulation which does not allow just compensation for railroad services deprives it of property without due process of law. And "the basis of all calculations as to the reasonableness of rates to be charged by a corporation maintaining a highway under legislative sanction must be the fair value of the property being used by it for the convenience of the public." [22]

Is there any significance in the fact that the court, having the

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[17] Reagan *v.* Mercantile Trust Co., 154 U. S. 413 (1894).
[18] McCullough *v.* Maryland, 4 Wheat. (U. S.) 316 (1819).
[19] 156 U. S. 649 (1895).
[20] 164 U. S. 578 (1896).
[21] 169 U. S. 466 (1898).
[22] *Ibid.*, 546.

choice of two possible theories, each achieving virtually the same result, finally accepted the property theory and rejected the contract theory? Does it throw any light on the subsequent course of judicial decision? Since the court does not itself give any reasons for its choice, one can only speculate. But it seems to me that the choice has some significance.

For a court composed of nine jurists, appointed for life, to annul a legislative expression of the popular will is always a delicate matter. To upset a law which has behind it the political passions and aspirations of a great popular movement like the granger movement of the seventies, requires particular circumspection. Above all, the judges must have been anxious to avoid the suspicion that they were substituting their own discretion for the will of the legislature. Their decision must rest on judicial, not on legislative grounds. A court acting judicially ascertains facts, and applies to them rules derived by certain processes of reasoning from established principles or precedents. A public body with legislative powers ascertains facts, perhaps, but it applies to these facts its own sense of what is in the public interest. Now the word "reasonable" carries with it a large suggestion of legislative discretion. No process of juristic reasoning can point with certainty to the precise limit beyond which a rate ceases to be reasonable. For twenty years the court had been saying that the issue of reasonableness was a legislative and not a judicial question. But a decision based on the rule in *Smyth* v. *Ames* would have at least the illusion of juristic necessity. What the value of a railroad was, seemed on the surface to be a pure question of fact, and a fair return could easily be ascertained by reference to current rates of profit. A judge who upset a state statute on the ground that it failed to allow a reasonable return on the fair value of the property seemed protected against any charge of usurping legislative power. He need only point to the ascertained facts, and shift all responsibility to the framers of the Constitution.

Certainly the language of the cases subsequent to *Smyth* v. *Ames* in the main bears out the hypothesis that the court has been trying to ascertain not a rule of policy, but a discoverable fact. The question has been, not what is it wise to allow the company to earn, but what is the value of the property on which it must be allowed to earn a return. In *Smyth* v. *Ames* the court enumerated

seven factors which were to be taken into account "in order to ascertain that value," — cost of construction, cost of improvements, amount, and market value of stocks and bonds, present cost, probable earning capacity, and operating costs. It suggested that there might be other factors. But these were merely different kinds of evidence, to be given such weight as they deserved. They were like the instructions of the court to a jury in eminent domain proceedings. The court instructs the jury that they must find, as an ultimate fact, the market value of the property in question. Perhaps it will enumerate the different kinds of evidence submitted at the trial, bearing on this ultimate question. The evidence may be contradictory, and the methods of valuation of the expert witnesses may have been inconsistent. But it is for the jury to give to each item of evidence such weight as in their judgment it deserves. The only requirement is that their ultimate finding must be a finding of fact. They must make up their minds what the property is worth, not what they think the owner should in fairness receive for it. No other explanation of the Supreme Court's enumeration of inconsistent and contradictory factors in *Smyth* v. *Ames* seems to me possible. The court was addressing the masters in chancery and the lower federal courts, and instructing them what ultimate fact they had to find, and what evidence they could consider.

On the whole, although there have been some suggestions that a rate schedule must be "just both to the company and to the public," [23] this conception that rates should be based upon an ultimate fact to be determined by inquiry has persisted. "What the company is entitled to demand . . . is a fair return upon the reasonable value of the property at the time it is being used for the public." [24] The price paid at a recent foreclosure sale is "evidence" of value.[25] The cost of reproduction is "one way of ascertaining the present value" of a public service corporation.[26] The cost of reproduction is "of service in ascertaining the present value of the plant," but it is not conclusive.[27] That mere conjecture is insufficient to justify overturning state legislation "is true of asserted value as of other

[23] San Diego Land Co. *v.* National City, 174 U. S. 739, 758 (1899).
[24] *Ibid.*, 757.
[25] San Diego Land & Town Co. *v.* Jasper, 189 U. S. 439, 443 (1903).
[26] Knoxville *v.* Knoxville Water Co., 212 U. S. 1 (1909).
[27] Minnesota Rate Cases, 230 U. S. 352 (1913).

facts."[28] This conception that there is a fact which can be discovered, if we are only persistent enough in our search for it, and which, once it is found, will provide a mathematical solution of all rate-making problems, is widely prevalent outside the Supreme Court decisions. Congress has instructed the Interstate Commerce Commission to "investigate, ascertain and report" the value of all property owned or used by common carriers.[29] It is the general practice of many state public service commissions to conclude their opinions with "findings of fact" as to the value of the utility in question. Indeed a general technique seems to have been developed, among state commissions, the object of which appears to be to render their decisions proof against reversal in the courts. The commission inquires minutely into the several "evidences" of value enumerated in *Smyth* v. *Ames:* original cost, cost of reproduction, capitalization, value of stocks and bonds, etc. It then marshals the figures, of course widely divergent, which these different lines of inquiry produce, and concludes somewhat as follows: We have considered carefully the facts which the Supreme Court has directed us to consider, and have given to each fact such weight as in our judgment it deserves. We therefor find that the value of the property is so and so. The final figure evolved generally bears no arithmetical relation to any of the evidentiary figures which the commission has "taken into consideration" and no indication is given of the logical process by which the figure is reached.[30] A court which is reviewing such a decision obviously finds it exceedingly difficult to hold that a wrong method was applied in valuing the property, since it is not clear what method, if any, was in the commission's mind. Unless the net result is clearly unjust, the court is more than likely to treat the whole question as one of fact, on which the decision of a fair-minded board which considers all the evidence is virtually conclusive.[31]

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[28] San Diego Land & Town Co. *v.* Jasper, 189 U. S. 439 (1903).

[29] Valuation Act, 37 STAT. AT L. 701.

[30] See, for instance, *Re* Champaign & Urbana Water Co. (Ill. Pub. U. Com'n), P. U. R. 1919 E, 798, 825. Harbster *v.* Angelica Water & Ice Co. (Penn. Pub. S. Com'n), P. U. R. 1918 E, 540, 548. *Re* Western Col. Power Co. (Colorado P. U. C.), P. U. R. 1918 E, 629, 648. Pub. Serv. Com'n *v.* Pac. Tel. & Tel. Co. (Washington P. S. C.), P. U. R. 1916 D, 947, 959. *Re* Valuation Missouri Southern R. Co. (Mo. P. S. C.), P. U. R. 1916 C, 607, 648.

[31] As in Van Dyke *v.* Geary, 244 U. S. 39 (1916)

II

Smyth v. *Ames* closed the first great chapter in the judicial history of rate regulation in the United States. The conflicting desires which plagued the Supreme Court in the granger and railroad commission cases were reconciled by the unanimous adoption of a formula which conceded what the majority of the court desired, the power to regulate, and yet guarded against what the minority feared, confiscation. The second chapter was already opening. What content should be given to the general terms of the formula? The formula implied a business relation between the railroad and the public. A certain service was to be performed and a certain measure of compensation to be paid. But what were the detailed terms of this hypothetical agreement? What risks was each side to assume? What meaning should be ascribed to the word "value," and what was a "reasonable return"? To any one familiar with the intricacy and refinement of detail in any business contract involving large sums and complex relations it must be apparent that the general language of the rule in *Smyth* v. *Ames* could only be regarded as a preliminary formulation, and that the task of giving it precision of meaning and fullness of detail still lay in the future.

The answer to these questions is obviously not to be found in *Smyth* v. *Ames* itself. Sometimes a court uses a word to which it ascribes a clear and definite meaning, but which to the reader is ambiguous. In such a case a minute inquiry into the context, the facts of the case, the precedents and the theoretical probabilities, may reveal just what it was that the court meant. But a mere grammatical inquiry of this sort is of little use in interpreting the rule in *Smyth* v. *Ames*, for the ambiguity of the words "fair value" is of a different sort. It is more probable that the court did not have in its mind any clear definition of the phrase. Consciously or unconsciously, it used words which merely described a large area of possible meanings. The use of such words of indeterminate meaning is not uncommon in jurisprudence, and almost universal in political discussion. Whether or not the court was originally aware of the ambiguity is of no importance. It must sooner or later have realized it, and intentionally left it to the future to decide what signification the term should have.

Before inquiring in what manner and to what extent the Supreme

Court has accomplished this task, it will be helpful to consider more carefully the elements involved in the business relation which the rule of *Smyth* v. *Ames* covered. Juristically, the problem may be to construe and interpret certain general concepts, such as property, due process of law, just compensation, but mere analysis of juristic concepts will not carry us very far. For the moment let us forget the Fourteenth Amendment and the nature of property. Instead of deducing a rule of rate making from a definition of value, or from a theory of the police power or of the nature of judicial and legislative functions, let us consider the matter pragmatically, as a problem in practical statesmanship.

The community requires certain transportation services. It is willing to pay for them, but for practical reasons, or perhaps because of certain historical and political preconceptions, it does not wish to undertake the construction and operation of the necessary facilities through its own gevernmental agencies. A group of citizens with financial resources form a company and offer to perform the services for the community, provided a satisfactory agreement can be reached as to the terms on which the services shall be performed and paid for. The agreement is obviously one of the very greatest importance, both in the magnitude of the financial interests involved, and in the vital effect which it will have on the business development, the health, and the prosperity of the community. One might naturally expect that the leading principles of such an agreement would be debated with the greatest thoroughness, and that they would be embodied in a written instrument in which the reciprocal rights and obligations of the respective parties were set down with the utmost clarity and refinement of detail.

Let us visualize the negotiations which might lead up to such an agreement. A committee representing the community is closeted with a committee representing the company. We will assume that a certain consensus of opinion has already been achieved. The committee for the public has rejected the company's proposal that the government should give a financial guarantee of operating expenses and a fair profit. The company has rejected the counter proposal that a fixed schedule of rates be embodied in the contract, the company taking the risk of increases in operating expenses and of fluctuations in the volume of traffic. It is agreed that the company shall look for its compensation to the fares and freight charges,

and not to the public treasury, and that the level of rates shall be under the control of a regulating tribunal, and shall vary with the larger fluctuations in costs of operation. "We are not now asking for a guarantee," the president of the company points out. "If business is so poor and expenses are so high that the traffic will not bear rates high enough to earn a profit, we are willing to stand the loss. If business is good, and expenses low, we are willing to let you cut down our rates to a fair profit. All we ask is that if our profits are too low, and if higher rates can increase them, you will let us raise our rates."

The proposal seems a sensible one, and the committee for the public withdraws for a few minutes for discussion. A lawyer among them, and also an economist, are seen to speak earnestly to the chairman, and as soon as the conference is resumed, the latter takes up the conversation.

"Of course you did not mean," he begins, addressing the company delegates, "that we should let you at all times charge rates high enough to give you a profit, regardless of the efficiency or lack of efficiency of your business. If you see fit to employ an incompetent general manager, of course you do not expect our constituents, your customers, to bear the burden of his incompetency. We have every confidence in the integrity of you gentlemen, but your successors may be of a different stripe. Suppose they should make a grievous mistake, and order a lot of engines of a type poorly adapted to your road, so that your trainload would have to be cut down and your speed reduced? Or suppose even that they should organize a car construction company, and buy freight cars from it at exorbitant prices? You catch our point. Doubtless you will not object to our putting into the agreement the qualifying words, 'so long as the property is operated honestly, progressively and with the highest efficiency and technical ability.'"

The representatives of the company of course agree in principle, although the company's attorney suggests substitution of the word "reasonable" for the words "the highest." After all, the community cannot expect them to employ the very highest talent in the country, regardless of cost. But they point out that the qualification suggested by the public representatives introduces into the agreement a most undesirable element of uncertainty. Who is to decide what is reasonable efficiency? Surely that is a matter

on which men of equal ability and experience can differ widely. Suppose there is a disagreement between the company and the community? Who is there that has the infinite wisdom, the universal experience, and the supreme impartiality to render a true decision? The public representatives admit the difficulty, but ask that it be postponed for the time being, while they pass on to the second point.

"There may be," the chairman continues, "some unforeseen development, which cannot be guarded against, which seriously depletes your earnings. Suppose, for instance, a great public catastrophe, a fire, an earthquake, a flood, which not only interrupts traffic, so that your income is lessened, but greatly increases your operating expenses. Or suppose there is a prolonged strike. Do you expect us after such an extraordinary event to increase your rates until you have recouped the loss? Or imagine a loss due to a mistake in judgment, which is not so reprehensible as to amount to negligence. Who is to stand that loss?"

"That, of course," says the company's president, "would be an ordinary expense of operation. You can expect us to be reasonably efficient, but you cannot expect omniscience. You cannot expect our foresight to be as wise as your hindsight. As long as we behave like ordinary reasonable business men, we are entitled to our fair profits."

"But are you not overlooking the fact that every business man assumes the ordinary risks of his business?" interposes the economist in the public delegation. "If you were investing in a clothing factory, you would stand the risk of fire, earthquake, and flood. Direct fire loss, perhaps, we might be willing to let you insure against, and we would not object to your charging the premium to operating expenses. But the risks of business disturbance, of strikes, of unavoidable mistakes of judgment, fall on every business man, and we see no reason why they should not fall on you."

The company negotiators point out that their business will be different from an ordinary private undertaking, and their attorney says that Lord Hale once described such a business as "affected with a public interest." A long discussion ensues, and it is finally agreed to postpone settlement of this point till the question of profits is reached. For the company representatives insist that if

they are to assume any risks other than those arising out of their own negligence, they should be amply paid for it.

The discussion shifts to the question of what profit is to be allowed, and many divergent views are expressed. The company representatives first suggest a percentage of expenses, but the proposal proves unacceptable for obvious reasons. The public negotiators suggest a lump sum annually, to be specified in the contract, but it is pointed out that in the course of many years business may increase enormously, and it may be necessary to sink larger amounts of capital and assume larger risks, so that a lump sum which is adequate to-day may prove inadequate ten years hence.

The company's attorney then suggests that it be allowed always a certain percentage on the value of the property. If value goes up, rates should go up proportionately. But the economist points out that the only accepted and sensible meaning of the word "value" is "value in exchange," — the amount which the property would bring at a free sale, and that obviously this depended mainly on earnings. "But earnings," he said, "will depend partly on what we allow you gentlemen to charge the public. If we reduce your rates, your value goes down. If we increase them, it goes up. Obviously we cannot measure rates by value, if value is itself a function of rates."

Finally, some one suggests that rates be fixed so as to bring as nearly as possible a fair return on the amount of money actually invested in the undertaking. If the business expands and more capital is sunk, the return will automatically increase. If some of it proves unprofitable and is abandoned, the return would automatically decrease. The chairman of the public group points out that of course such an arrangement would be subject to the qualification, already accepted as to operating expenses, that the investment on which a return is sought was honestly and efficiently made. The company negotiators agree in principle, although they point out again the large element of uncertainty which such a qualification involves. It is also agreed that the question of responsibility for reasonable mistakes of judgment in capital construction must be held in suspense until the rate of return is discussed. But the company representatives raise some more fundamental questions.

"The railroad," says one of their number, a banker, "will run into a region which is as yet undeveloped, but which I confidently believe has brilliant prospects. There is a city, for instance, in which we expect to build large terminals, and buy extensive real estate for roadbed and freight houses and passenger stations. The land will not cost us much to-day, but if my judgment as a business man is vindicated, it will some day be worth five or ten times what it costs to-day. Now we are taking the risk of the community languishing and failing to supply enough traffic to make the road profitable. Are we not entitled to a share in the general prosperity of the country? If our real estate investment appreciates, are we not entitled to reap the rewards of our business acumen in selecting the site? Every other business gets such a reward if it is wise in its real estate purchases, so why should not we?"

"That is true also of our investment in work and materials," says another of the company representatives, an engineer. "It so happens that this year, as you all know, is a year of great business depression. There is little free capital for investment or expenditure, and business is stagnant. Owing to the unusual resources and conservative financial policies of the gentlemen who compose our group, we have been able to raise the necessary capital now, to take advantage of the period of depression. Soon prices will take an upward turn. Those of you who have studied curves of business cycles will agree that that must be so. Are we not to get a return on the greater value which will inhere in our plant when the general level of prices has gone up? Are we to be penalized because our foresight and resources enabled us to have capital available while prices were low, instead of waiting till they were high?"

"Take another aspect of the situation," resumes the banker. "In my home town, through which the proposed railroad will run, the citizens were so anxious that their town should be included in the line that they offered, through the town authorities, to give several acres available for terminal facilities and roadway, free of charge. Now of course that property is worth something. The fact that they are donating it does not take away a cent of its value. The gift is a purely private arrangement between the town and the railroad, in which you gentlemen are not at all concerned. The community will get just as good service whether we pay for the

land or not. It does not seem right that you should take away from us the gift which the city has for reasons of its own seen fit to bestow on us. Yet that is exactly what your theory of allowing us a percentage on our actual investment would do."

"There is another point," the president adds. "You speak of the actual cost of the business — the cash investment which we will have made. Are you not forgetting that we are investing more than mere cash? The plant will be worth more than the mere dollars and cents put into the individual items of real estate and rolling stock and improvements. We are investing not only our cash, but our reputation, our business experience, our energy and initiative. We will give you a living, working organism, not merely the bare bones, the *disjecta membra*, of land and steel and wood. Moreover the members of our group have a reputation in the community, and, I may add, a certain popularity, which will strongly influence the public toward patronizing our line. And does not the fact that the public has entrusted us with this vastly important public undertaking (assuming that these negotiations are successful), and given us a valuable franchise from which all others are excluded, does not that fact of itself add to the value of our property? Every business man knows that these intangible elements — the value of our plant as a going concern, the value of its good will, and the value of its franchise — are among the most important possessions of a company such as ours."

The chairman of the public negotiators is somewhat taken aback by these arguments. In private life he is a department-store proprietor, and his income has kept pace with the growth and prosperity of the city. But the lawyer comes to the rescue.

"That would be all very well, gentlemen," he says, "if you were going into a purely private business. But as my brother on the other side has so well said, transportation is affected with a public interest. It is in its nature, if I may use the word, a governmental function. If the government cared to, it could go into the business itself, and operate the railroad as a public service, without any profit above the interest on its bonds. Moreover it is in a sense a monopolistic business. To acquire the right of way for your roadbed, you will need to exercise the right of eminent domain, a right which we can give or withhold at pleasure. Before a competitor can cut

into your field, he must get a franchise from us, and although we cannot of course guarantee you a perpetual monopoly, yet we know that competition is a dangerous and disturbing element in railroading, so that as a practical matter we are likely to leave you in possession of the field."

"Moreover," interposes the economist, "a railroad requires an unusual amount of fixed investment before it can be put into operation, and hence there must be a promise of a large amount of business before capitalists will venture to enter a field in which a company is already installed. So that there is an unusual degree of what I may call natural monopoly, quite apart from any legal restrictions which may exist."

"What is the conclusion to be drawn from the fact that your undertaking is a quasi-public one, and that it is semi-monopolistic?" continues the lawyer. "Is it not precisely that you are to be treated differently from men who engage in an ordinary competitive venture? That you are not to be allowed to charge what the traffic will bear? You are asking us for a franchise. If we give it to you, it will be in order that you may serve the public at reasonable rates, not so that you can make an undue profit out of the public. You are given a right of eminent domain, with which you are able to acquire land at reasonable prices. That right is a sovereign right, which exists under the constitution only for public purposes. We would be betraying our trust if we were to let you forcibly appropriate another's land by the exercise of a governmental right, thus depriving him of the possibility of enhancement of value, and then convert that land into a source of private enrichment. What you paid for the land, provided it was reasonable, was a legitimate investment, on which you are entitled to a return, but any increment belongs to the public. Or take the land which you expect to receive from the city authorities. Can we assume that the city is giving you that land to swell your own private incomes? Surely the object of its benevolence is the public. A city would be acting beyond the scope of its municipal powers if it gave away municipal property for the private benefit of a few individuals. We must assume that it gave you the land, so to speak, in trust for the public, and that the public is to get the benefit in the shape of lower rates."

"Besides," adds the economist, "how are you going to measure

these intangible rights you speak of? Your good will, your franchise, your status as a going concern, have no value, in any accepted sense of the word, except as they contribute to your earning power. As a congeries of wood and iron, without a franchise to operate and collect fares, and without customers, your plant is mere junk. Earning power gives it value. But earning power, as I succeeded in convincing you this morning, is entirely dependent on rates. Your intangible rights are worth just as much, and just as little, as we decide to make them.

"Another point occurs to me," he continues. "You are asking that the amount on which a percentage of profit is to be earned shall include certain elements which we economists call unearned increment. This year your land may be worth a million. Ten years from now it may be worth two millions. You claim this year a rate sufficient to give you a return on the million, and ten years from now a rate sufficient to give you a return on the two millions. But if your property has been appreciating at the rate of a hundred thousand a year, why is not that hundred thousand dollars to be treated as a part of your income, just as much as the fares and freight charges paid by the public? Is it not income reinvested in plant? Income is that which induces the capitalist to sink his capital. When capital is sunk in land, the inducement is not merely the annual cash earnings, but the probable annual appreciation. My friend here (turning to the banker) can doubtless tell of many cases in which money has been sunk in real estate without any prospect of cash return in the near future, merely because the value of the land was expected to go up."

The discussion waxes warm. The company attorney disputes the contention of the lawyer for the public, and asks if capital devoted to railroading is not just as much private property as capital invested in a department store, so long as its public obligations are fulfilled. "Is there any reason," he asks, turning to the economist, "why property should be confiscated merely because its value is hard to ascertain?" The engineer suggests that the value could always be ascertained by estimating the cost of reproducing the plant, new, at a given time, and making a reasonable allowance for depreciation. The intangible elements, he says, could be ascertained by assuming a phantom plant, ready for operation without any customers or good will, and estimating the cost in advertising,

loss of profits, etc., of building up the business. To which the reply is made that in fact a business is never reproduced in this way, as a single unit, that the plant is built or improved and extensions are made when the labor and material markets are favorable, and that good will is built up gradually by judicious soliciting, by publicity, by the self-advertisement which springs from the mere fact of successful operation. And the expense of this acquisition of patronage will generally be charged to the operating account, and so will already have been paid for by the public. Finally the chairman of the public delegation, who has for a while allowed the others to carry on the debate, gets up from his chair and asks for attention.

"Gentlemen," he says, "I have listened with great interest to the discussion, and especially to what my good friends the lawyers on both sides have been saying. Some of it, especially that about Lord Hale, I confess I did not quite catch. Sometimes my friend the economist, here, got beyond my depth. But I think we can all of us understand the main points about which we've got to agree. My lawyer friend here has given us a theory which would decide all the disputed points in our favor. My lawyer friend on your side has given a theory which would decide them all in your favor. But, gentlemen, we are practical men. We have a practical business proposition to settle. Let's look at it in a practical way. We want a road built. We could build it ourselves, but we don't want to if we can help it. We could get some other group of gentlemen to do it for us, but we think we can make a reasonable arrangement with you. You gentlemen, on the other hand, have capital, and business ability, and a willingness to run some risks. You might invest your money and brains in some other line of business — in manufacture, or construction, or mining, or shipping. But you are ready to come to a reasonable agreement with us.

"First let us see just where we stand. We are agreed that you are to be allowed to charge a freight rate which (assuming there is enough traffic) will permit you to pay your operating expenses (provided you are operating honestly and efficiently) and a return on so much of your investment as was honestly and efficiently made. We haven't yet agreed whether you or the public are to take the risk of loss from extraordinary events, such as earthquakes and

floods and strikes, or of unavoidable mistakes in judgment. We are at odds on the question whether you are to get the benefit of increased land values, or of appreciation in your plant due to higher prices and labor costs. We disagree as to the amount which is to be added, if anything, on account of franchise value, good will, or the value of your road as a going concern. On the other hand we haven't discussed at all the most important question of all, the percentage of return you are to get each year once the value is determined.

"I think, gentleman, that we understand each other. I believe that the time has come for a reasonable compromise, and that if we bear in mind the welfare of the community, for which we are all working, we can settle the matter this afternoon. There is only one thought I would like to leave with you. The items on which we are still in dispute are interdependent. One hangs on the other. If you are to assume the risks of earthquakes, floods, and strikes, or of unavoidable mistakes in construction or operation, you will insist, and rightly insist, on a larger percentage return to compensate you for that risk. If we assume those risks, we are entitled to ask you to be content with a lower rate of return. If you are to get the benefit of what my friend calls the unearned increment, that is an added attraction which the community is offering you, and which should induce you to accept a very moderate rate of annual return; if you are to get a return only on the money actually invested, you will be reasonable in demanding a larger rate of return. Your business experience and foresight and reputation must no doubt be compensated, either by taking your services into consideration in fixing the rate of return, or by agreeing on some reasonable sum as the capital value of those services, and including it in the valuation. Those, I think, are the elements out of which our agreement must be made. Let's forget Lord Hale, and get together on a sensible basis."

Anyone familiar with business negotiations can imagine what the outcome will be. There will be give and take. Each side will concede something. One point will go in favor of the government, another in favor of the company, without much regard either to legal principle or economic theory. Just where the compromise will be, must depend on a number of strategic factors — on the strength of the capitalists' desire to undertake the enterprise, and

of the government's desire to have them do it, on their relative bargaining powers, perhaps on the toss of a penny. What is yielded in valuation may be reclaimed in rate of return. Perhaps the public representatives will be strong enough to gain almost all their points; perhaps they will be weak enough to concede almost all. Somewhere a compromise will be hit upon. Then the lawyers will get together and draw up the results of the negotiation in a document which expresses in legally effective language the practical compromise which has been reached.

III

My object in rehearsing this imaginary negotiation has been to bring out the true character of the hypothetical contract which the rule in *Smyth* v. *Ames* implies. Many business transactions are entered into without a clear formulation of terms. A man visits a doctor; he does not generally settle in advance the fee which he is to pay. A woman buys two pounds of sugar at a grocery store; she may not know till the end of the month what the price is. Where there is a simple transaction like the sale of a commodity with a current price, or performance of services which have a customary value, it is not impossible for a court to arrive, *ex post facto* with reasonable certainty, at the probable terms of the contract. Even if there is no standard by which the terms could be gauged, such as a market price, or a customary fee, there are currently accepted rules of reasonable conduct which make it possible for a court to reconstruct fair terms without doing substantial injustice to either party. But where the contract is virtually unique, where there is no accepted standard of reasonableness to which its terms can be referred, and where the relations which it determines are from their nature complex beyond measure, a court which attempts to deduce from general notions of reasonableness and customary fairness the unwritten and unthought terms of such a contract, made perhaps fifty years ago, is obviously attempting the impossible.

In no class of business agreements is the utter impossibility of attempting to reconstruct *a posteriori* the probable terms of a non-existent contract more apparent than in the case of agreements involving an element of extraneous risk. An insurance contract is a typical example. The insured is to pay a certain premium, and

the insurer is to pay a certain principal sum if certain contingencies happen. If the court knows neither the premium which is to be paid, nor the contingencies upon which payment of principal depends, obviously it cannot reconstruct the contract along general lines of reasonableness, or by guessing at what the parties probably meant. The premium might have been large, and the contingencies probable, or the premiums small and the contingencies remote. Either alternative would have been equally reasonable, and equally probable.

The relation between the owners of a public utility and the government is not a standardized relation. There is no generally accepted norm to which a contract embodying such a relation can be assumed to conform. It is not a simple transaction, like the sale of a current commodity, or the performance of customary services. And it involves to a large degree the element of extraneous risk. The probable earnings depend upon a number of contingent factors, some within the control of the owners, some within the control of the government, others beyond the control of either. The risk of loss or chance of profit from any one of these contingencies, and especially from those which are beyond the control of either party, may fall on the company or on the community, and in many cases it is impossible to say whether it should more reasonably fall on one or on the other. It all depends upon who pays or receives the theoretical insurance premium against the happening of these contingencies.

I have already indicated, in the imaginary negotiations which I have portrayed, some of the uncertain factors in the public utility relation. What standard of reasonableness or what law of probability can determine whether the company or the public shall stand the risk of unforeseeable catastrophies or of reasonable mistakes of judgment? Or which side to the bargain shall get the benefit of unearned increments of value, or of the cheaper unit costs of operation and larger gross revenues due to the growth of the community? There are at least two other elements of uncertainty, of the most far-reaching importance.

Obviously there is no mathematical relation between earnings and rates, although courts and commissions sometimes speak as if there were. The level of rates is only one of the three major factors which affect earnings. The other two are the level of expenses,

and the volume and character of traffic. A regulating commission may fix a schedule of rates designed to produce say a seven per cent return on a given valuation. But there may be a slump in traffic, or a temporary rise in operating expenses, which cuts down the actual return to five or four per cent. What disposition is to be made of this "deficit"? Or the deficiency may arise in the early development years of the company's life, before traffic has reached its full volume, and before the machine is working smoothly. Is the company to be reimbursed for such deficiencies, or are they among the risks which it assumes? If it is to be reimbursed, in what manner? Obviously there are many possibilities. A distinction might reasonably be made between differences due to miscalculations of the commission as to probable operating expenses, and deficiencies due to insufficient traffic. To begin with the first. Shall the commission each year, in fixing rates for the ensuing year, take into account its own under- or over-estimate of expenses the previous year, and correct the award for the ensuing year by adding or subtracting the amount of the previous miscalculation? Theoretically such a procedure would perhaps be correct; but it is equally probable that in view of the almost insuperable difficulty of determining how much of the deficit or surplus was attributable to the miscalculation, and how much to other causes, the government would insist that its good faith and fairness be taken for granted, and that the company be satisfied with the regulating body's general duty to act fairly and to the best of its ability. Deficits due to lack of traffic offer even greater difficulties. It may be assumed that the government has not under any circumstances agreed to make good losses out of its own treasury. But suppose that during the early years of development traffic was light, but that in later years it has grown to remunerative proportions. Is the company entitled to recoup its early losses out of subsequent earnings? If so, in what manner? By calling the early loss a capital investment, part of the cost of production of the business as a going concern, and hence part of the fair value on which future annual returns are calculated? Or by recouping the losses as rapidly as the traffic will bear? Or by amortizing them over a period of years? Or shall the early losses be deemed one of the business risks which the company has assumed, and for which the annual return is deemed a fair compensation? Ob-

viously any one of these alternatives might reasonably have been agreed upon.

A similar problem arises when a company for some time in exclusive possession of the field is suddenly subjected to competition, and its earnings materially reduced. If after a few years the competitor is eliminated or bought out, or if traffic develops in sufficient volume to make both railroads profitable, are the competitive losses to be recouped, or are they, too, among the risks assumed by the company?

The second element of uncertainty arises out of the rate-making practices of the railroads. It is a well-known fact that under a commercial system of rate making certain commodities are carried at a rate so low that while perhaps they bring in their out-of-pocket expenses, they add little if anything to the continuing costs of operation or to the fixed charges or dividends. The state of the law appears to be that while a railroad may of its own volition reduce rates to such a level, for reasons of commercial competition, without incurring the charge of unjust discrimination, nevertheless the government cannot constitutionally force a railroad to make such special rate reductions, even if the net result of all its operations is to bring in a fair return.[32] Assume that a railroad has made such competitive reductions on a substantial number of commodities. Has it a constitutional right to recoup the deficiency in net earnings from these commodities out of such of the traffic as will bear a higher rate? Or are the losses from its competitive ventures for its own account?

Thus it is apparent that were we privileged to transport ourselves back to the days in which railroads were built, even if we could carry with us all the economic and juristic wisdom which the last quarter-century has produced, we would find it impossible to indicate any true economic or legal principle of rate making. We could not, however acute our perception, point to any one criterion of reasonableness, and say that it and it alone was sound. Essentially, it would be a subject for business agreement. A lawyer might point out that a certain combination of terms would leave a loophole or an ambiguity not contemplated by the parties. An economist might point out that another combination of terms in-

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[32] Northern Pacific *v.* North Dakota, 236 U. S. 585 (1915).

volved practical consequences injurious to one party or the other. But when both lawyer and economist have had their say, there would still remain a substantial variety of possible adjustments, each different from the other, and each nevertheless accomplishing the primary objects which the parties had in mind.

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(To be concluded)